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(U) CHINA: SOME IMPLICATIONS OF INDUSTRIAL REFORM

Summary

The Chinese Communist Party plenum in October 1984 gave Deng Xiaoping a mandate to take wide-ranging action to revise China's planning, pricing, wage, and management systems. By scrapping Stalinist methods, China's leaders are seeking to increase efficiency and productivity and to promote greater specialization and more rapid technological change--advances they identify as crucial to the attainment of ambitious goals for economic development. Industrial reform could alter China's economic structure if the leadership perseveres. The reform, however, does not entail the abandonment of socialism.

Obtaining the mandate apparently required some compromise on the part of the reformers, led by Deng, on the scope of reform. The state will remain in control of production and distribution of basic agricultural and industrial products. Price reform, which is pivotal, is to proceed cautiously. Amplification of the reform proposals in coming months could be difficult if controversy resumes in the leadership over the advisability of relaxing state control over investment and prices and expanding the roles of enterprise managers and markets. Furthermore, lower level party officials are likely to resist efforts to reduce their influence over economic affairs.

In the near term, the reformers appear to have sufficient political strength to keep the thrust of reform intact. If they succeed in enacting bold reform measures, the quality and mix of industrial output should improve. But the rate of industrial growth is likely to slow compared with increases achieved in recent years as enterprises adjust to higher production costs resulting from price reform.

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Over the longer term, the success of reform probably will rest more on how well the current leadership handles likely bouts with inflation and rising unemployment than on how completely the reform meets its stated objectives. Inflation is the more dangerous challenge because policies that would be required to restore price stability also could undercut the reform. Left unchecked, however, inflation would shatter the consensus on policy that Deng and his supporters have worked so hard to achieve and, in the process, could imperil their leadership.

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### Conditions Ripe for Reform

The immediate pressure for proceeding with industrial reform in China stems mainly from political factors, including Deng's age and the need to secure his policies and the succession. By acting now, the leadership should be able to get reform regulations in place before China embarks on the 1986-90 five-year plan, and it could use the targets of the plan to increase the number and influence of those having a stake in the continuance of current economic policies. Deng already had achieved agreement on the need to remedy defects in Stalinist methods that retarded modernization of industry, misallocated investment, wasted labor and materials, and stifled individual incentive.

Improved economic performance over the past few years, particularly in 1984, may have provided the leadership a platform on which to promote the reform:

- In agriculture, China harvested its fourth successive record grain crop in 1984. Expected to exceed 400 million tons, grain production is large enough to reduce imports and permit some exports. The cotton crop--estimated at 5.5 million tons--also is a new record. Impressive results of agricultural reform (begun in 1979) buttress the case for industrial reform, even though the leadership cautions that improvements in industrial performance would be smaller and more difficult to achieve.
- Industrial production posted double-digit growth in 1984 for the second consecutive year according to recent Chinese estimates. Based on nine-month data, the State Statistical Bureau projected a 12.5-percent increase in industrial output, compared with 10.5-percent growth in 1983. Better balance in growth also was anticipated; output was expected to grow by 11 percent in light industry and by 13 percent in heavy industry. In 1983, production by light industry rose by 8.7 percent and heavy industry, by 12.4 percent.
- During January-September 1984, the volume of foreign trade rose by more than 20 percent and China's trade surplus amounted to \$350 million. Foreign exchange reserves totaled about \$17 billion at mid-year. Large foreign exchange holdings (equivalent to 8 months of imports) and a high level of

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confidence among lenders regarding China's creditworthiness will cushion the impact of spending to retool China's factories.

#### Economic Pressure for Reform

Rapid growth has exacerbated a number of fundamental economic problems, making the need for reform more acute:

- Increased agricultural production, especially of grain, has led to growing state purchases. Greater sales of foodstuffs at prices below acquisition cost have driven up the cost of subsidies. According to the Chinese economic research office and International Monetary Fund calculations, price subsidies rose from about 14 billion yuan in 1979 to 33 billion yuan in 1982--accounting for more than 32 percent of gross state financial expenditures that year. Price subsidies have increased further, although more slowly, during the past two years. The state also is incurring substantial increases in storage costs because of the greater-than-expected boom in agricultural output. Rapidly rising income in rural areas has increased demand for agricultural investment goods and other farm inputs, construction materials, and consumer goods which the industrial sector is increasingly less able to satisfy.
- The rise in industrial production has not been accompanied by sufficient increases in the marketability of goods produced. During January-September 1984, for example, the amount of funds locked up in unsalable inventories (at existing prices) increased faster than the growth in output of finished goods, according to the Ministry of Finance. Moreover, while some progress was made in cutting losses of unprofitable firms, the reduction was less than the planned amount. Deficits in a few important industries, such as coal mining and timber, are increasing faster than output.
- The State Economic Commission has reported that foreign trade losses during January-September 1984 were reduced, but no indication was given about the rate of reduction compared with this year's plan. The mounting trade surplus, however, is adding to the state's subsidy burden because foreign exchange earnings--converted into domestic currency--in general do not cover production costs. Last year, for example, foreign trade subsidies are estimated to have almost quadrupled. Some Chinese economists consider foreign exchange reserves excessive, implying that more imports should have been purchased to enhance supplies of consumer goods in the cities.
- Rapid growth of the Chinese economy has kept pressure on bottleneck sectors, particularly energy and transportation. The

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continued rise in government spending necessary to finance construction of dams, powerplants, highways, and railroads is threatened by the rising portion of the state budget consumed by subsidies. The budget deficit, in fact, has grown in the past two years, adding to problems with inflation.

#### Wide-Ranging Initiatives

An important shift suggested by the decision of the October 1984 plenum is an effort to proceed concurrently with the various reforms to planning, pricing, wage, and management systems. Before the plenum, public and private discussions by Chinese officials had indicated that price reform--including reduction of subsidies--was viewed as the most difficult task and would be tackled last.

Although no plan for price reform has been revealed, the timetable for initial adjustments appears to have been advanced. The period to accomplish price reform, however, may extend beyond that scheduled for other changes. Recently published remarks by Premier Zhao Ziyang show that he expects price reform to continue into the 1990s. Party General Secretary Hu Yaobang projects a more rapid pace for reform. In a speech delivered in late November and reported in the China Daily, Hu provided a 3-4 year timetable for price reform. Hu also said that wage increases would be granted first to prevent any decline in living standards, stressed that price adjustments would not be allowed to result in a rise in the price level, and pledged that the leadership would proceed with extreme caution.<sup>1/</sup>

None of the targets of reform is new and all had been described--at least in principle--in the press. Many changes already have been implemented on a selective, experimental basis. For example, above-quota production of rice and coal is being sold at floating prices. Decentralization also is under way. In at least two cities and in selected factories in some others, managers are operating factories independently of state ministries. Provincial and local officials, too, are taking on greater roles in economic decisionmaking, especially in foreign trade and in the allocation of investment for local enterprise development.

On October 4, two weeks before the plenum met, the State Council approved a set of provisional reforms of the planning system to take effect beginning in 1985. The number of product groups covered by compulsory state production plans will be reduced

<sup>1/</sup> (C) Hu's remarks probably were intended to assuage popular fears of an erosion of purchasing power. For example, news that the October plenum had approved a price reform sparked a consumer purchasing spree at retail outlets.

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from 120 to 60 in industry and from 29 to 10 in agriculture. In place of compulsory plans the state will rely on guidance planning and market regulation. A narrower focus for state control is also featured in planning of materials supply, domestic commerce, foreign trade, and wages. The investment plan will remain mandatory for projects financed by the state budget, but the coverage of the investment plan will continue to shrink.

#### Institutional and Practical Limitations

Retaining central command over key industrial and agricultural products<sup>2/</sup> will lessen the benefits of reform, but it also will provide a means for the state to contain undesired side effects. Products excluded from planning reform probably account for more than half of the gross value of industrial and agricultural output. By concentrating state control on production and distribution of industrial inputs, the leadership is ensuring against a wrenching dislocation of the economy--an event that could overturn the leadership as well as its policies.

Similar caution is likely to appear in managerial reforms. Officials have expressed concern about the capabilities of enterprise managers because many owe their positions to political connections and may lack the expertise needed to run factories independent of ministerial controls. These concerns probably were not mollified by results of a state-conducted test in August 1984: 94 percent of more than 9,000 managers passed a section on principles of business administration. This outcome suggests that the leadership is not insisting on very high standards and that the state may provide highly specific guidance to firms for some time.

Party influence in factory affairs--through the factory party committee--is being called upon to shepherd the transition to the new management system. Factory party secretaries will be judged by their progress on this task. In this fashion, the leadership may be trying to coopt one of the more likely resistance elements into support of the reform program.

Wage reform differs in thrust from other reforms and is pointed mainly at reversing past emphasis on egalitarianism. Wage differentials are to be widened to reward those with better skills and more responsibilities. To enhance worker incentives, wages and bonuses are to be increased to reflect gains in productivity and profits; and, where possible, wages will be calculated on a piece-

<sup>2/</sup> (U) This includes such products as fuels and power, ferrous and nonferrous metals, building materials, chemicals, selected machinery and equipment, grain, cotton, edible oil, and tobacco.

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rate basis. Wage levels, however, will not be set competitively in a labor market. The state will continue to determine the size of the wage fund, and decisions on its distribution will filter down to provincial officials and enterprise managers. Moreover, controls will remain in place which inhibit job-changing and migration to high-wage areas, blunting the influence of market signals to guard against too rapid urbanization.

### The Challenge of Inflation and Unemployment

Inflation is the most dangerous problem the leadership will face in the reform period. Hyperinflation 40 years ago led consumers to cherish price stability and to tolerate coupon rationing. Popular resentment could be raised by perceived lack of fairness in price rationing, an issue certain to be fanned by opponents of the reformers' policies. The reform also will worsen China's problem with unemployment. While unemployment will be a less tractable problem for government controls than inflation, it is less likely to generate social unrest great enough to threaten the leadership.

Inflationary Pressures. Price revisions are likely to result in a hike in the general price level, depending on the strength of the leadership's effort to make prices rational. The State Economic Commission expects that about 10 percent of China's industrial output will be freed from state price controls, according to a commission official interviewed recently by a Japanese newspaper. The leadership probably could brake excessive price increases for these goods. More upward pressure on the general price level is likely to result from price changes in the broad range of products that remain under state control. Fuel, particularly coal, is priced cheaply in China compared with both prevailing international prices and domestic costs. Higher energy prices would induce most industries to press for higher product prices.

In the consumer sector, higher prices for basic foodstuffs can be avoided if productivity continues to grow rapidly in the farm sector. Prices for quality foods, however, may escalate sharply as households attempt to improve their diets. Prices for manufactured consumer goods and construction materials also are likely to rise as increasing household incomes put pressure on supplies. In this respect, the one-time increase in the wage level, planned to maintain living standards, may feed inflation.

Unemployment Problems. The reform initially will slow the rate of job creation, intensifying unemployment. The state hopes to overcome any decline in the rate of job creation in the state sector by encouraging expansion of cooperative and small private ventures. The cooperative/private sector has grown exponentially during the past two years, especially in the area of services.

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Rapid growth rates, however, rest upon a very small base, and this policy is unlikely to keep the unemployment rate from rising. The government probably will avoid overly concentrated unemployment by selectively moderating its policies and will try to respond to complaints by raising expenditures on income maintenance programs.

Underemployment in industry is widespread. Because the reform is partly directed at encouraging factory management to become more profit-minded, managers are likely to use their expanded authority to trim the ranks of workers. The Chinese press already is citing examples of firms reducing the number of workers and obtaining increases in production. Factories that displace workers are responsible for locating work for these employees but are not required to find jobs that provide the same level of income. The political sensitivity of this issue will make managers cautious, and the number of underemployed workers could rise as factories are modernized. Large cuts in factory work forces are unlikely. More troublesome will be decisions on closure of unprofitable enterprises.

Compounding the state's problem, demographic factors indicate that the number of new entrants to the labor force will continue to rise as the reform is being implemented and extended. Light industry including textiles provided two-thirds of the new jobs in industry in recent years. This sector, however, will have the greatest difficulty adjusting to reform.

#### Problems of Growth, Investment, and Urban-Rural Differences

The initial adjustment, especially to price revisions, will be painful for many small, light industry factories that are profitable only because of the current structure of administratively set prices. Heavy industry will feel the effect of the drive to weed out inefficient firms but probably will have more time to adjust. Zhao expects that the rate of industrial growth may drop to about 7 percent during the 1986-90 five-year plan period. Even though reform probably will slow the rate of industrial growth over the next few years, it should improve the quality and mix of goods and services and reduce the proportion of products that accumulate in unsalable inventories.

Complications may arise from the plenum's call for focusing investment on upgrading existing factories. Imports of equipment and technology are projected to reach about \$14 billion during 1985-87, according to a recent announcement by Zhu Rongji, Vice Minister of the State Economic Commission. Purchases of machinery and technology from the West, however, could surge above this amount. Along with gaining more control over investment decisions, factory managers are being allowed more freedom to conduct trade. Trade deficits seem likely unless the central authorities

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limit managers' access to foreign exchange. But this would put the state back into the process of administrative rationing, undercutting the reform program.

Finally, reform could aggravate problems of unequal income distribution. The sensitivity of this issue centers on gaps in living standards between urban workers and peasants<sup>3/</sup> and between the more affluent provinces along the coast and the poorer provinces in the interior. Past policies have concentrated on narrowing differences in earnings and opportunities. Current policies emphasize rapid development of the coastal regions, prior to beginning large-scale redevelopment of the industrial northeast. Efforts to modernize more backward regions are far in the future.

The gaps in income distribution, therefore, probably will widen. How fast they widen will depend on trends in the terms of trade between regions and between various sectors in the economy and will be an additional result of price reform. Even if the leadership copes with more immediate challenges to reform posed by inflation and unemployment, it will have to grapple for years with a worsening regional problem because of the growth strategy it has chosen.

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<sup>3/</sup> (U) China's State Statistical Bureau recently reported that in 1983 the ratio of the standard of living between urban workers and peasants was 2.2:1. This is a substantial gap, but the ratio also is at its lowest level in the history of the People's Republic.

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